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Kenya Bankers Association Centre for Research on Financial Markets and Policy®

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Monetary Policy Stance – The Inevitability of Staying the Course

"The foreign currency reserves' position provides adequate cushion for the CBK to manage temporary shocks that may affect the foreign exchange market. That by no means implies that the CBK is either in a position or is desirous to influence the direction of the currency trend."

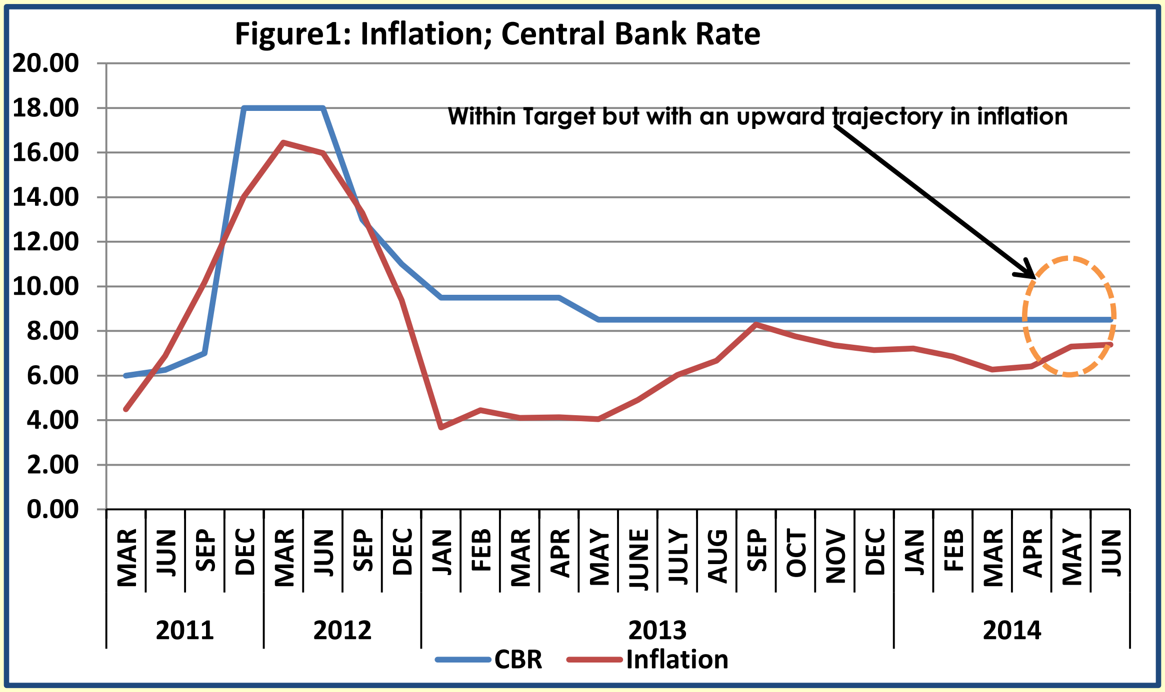
Highlights

- The decision of the Central Bank of Kenya's Monetary Policy Committee meeting of July 8, 2014 to hold the Central Bank Rate (CBR) at 8.5 percent was an affirmation of the desire to anchor inflation expectations.
- Informed expectations were that the CBR level will be unchanged. Nonetheless, the MPC's sanguine posture with regard to inflation outlook has to countenance the fact that new electricity tariffs come into effect in July 2014. This comes at a time when there is a possibility of an increase in food prices on account of supply constraints arising from erratic rains in quarter one of 2014.
- It is not just the local environment that begs for a continued pause in monetary policy stance. The external environment, particularly the geopolitical developments in Eastern Europe and the Middle East crisis have direct implications on domestic market dynamics.
- The interplay of such dynamics could result in at best slim possibility of the desired policy position of low interest rate. Even the successful Eurobond – on its own – may not lead to the low interest rates that official expectations are engendering.

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) is increasingly focusing its message on the core mandate of price stability. The decision of the MPC meeting of July 8, 2014 to hold the Central Bank Rate (CBR) at 8.5 percent was an affirmation of the desire to anchor inflation expectations. Informed expectations were that the CBR level will be unchanged. There was no scope for a reduction given that inflationary pressure is evident. The rate of inflation at the end of June 2014 was 7.39 percent, having risen from the May 2014 level of 7.30 percent, and is therefore only 19 basis points shy of the CBK's upper bound target.

Even without the MPC committing to an inflation outlook beyond the indication of confidence that its previous decisions continue to deliver the desired inflation stability, the reluctance to increase the CBR is understandable given that notionally the CBK is within its mandated inflation target (**Figure 1**). In any case we can argue that any preemptive policy adjustment will lean more towards pre-commitment than towards forward guidance.



Source: Central Bank of Kenya

Nonetheless, the MPC's sanguine posture with regard to inflation outlook has to countenance the fact that new electricity tariffs come into effect in July 2014. This comes at a time when there is a possibility of an increase in food prices on account of supply constraints arising from erratic rains in quarter one of 2014. This is a fact that has escaped the populist believe that the policy decision provided no reprieve for borrowers – implying that they expected otherwise[1].

External Geopolitics + Local Shocks = External Challenges

It is not just the local environment that begs for a continued pause in monetary policy stance. The external environment, particularly the geopolitical developments in Eastern Europe (the Russia – Ukraine debacle) and the Middle East crisis (previously the Syrian problem and now compounded the Iraq crisis), has a direct impact on oil prices.

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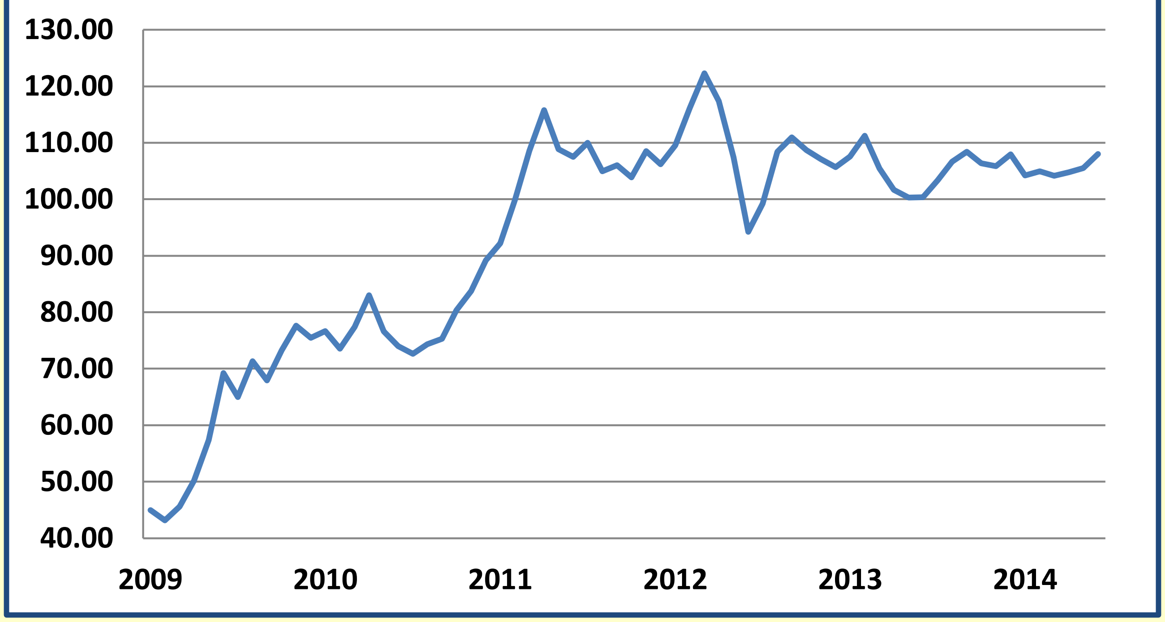
[1] *Business Daily*, July 9, 2014; "No reprieve for borrowers as CBK keeps policy rate at 8.5 pc"

Before the Iraqi crisis, the International Energy Agency projected a rise in economy's oil production to jump from the current 2.5 billion barrels per day (b/d) to 4.4 million b/d by 2015; that is unlikely to be realized. This comes at a time when Syria's production, once estimated at 400,000 b/d coming to zero and the prospects of normalcy in Libya's production being very low. All these have lifted the price of oil a little but points to the prospects that stability is just one of the possibilities based on the most optimistic scenario of strong stock and the main damage from the geopolitics is on expectations, the realistic scenario pointing towards a larger long term impact.

The high and potentially volatile oil prices, currently at about USD 115 per barrel (**Figure 2**) have an implication on Kenya's external account on the adverse side. Combined with the domestic insecurity that affects the tourism sector (one of the key foreign exchange earners), the ability of the economy's current account deficit to continue narrowing as officially anticipated is compromised.

Figure 2: Oil Prices (USD/Barrel)



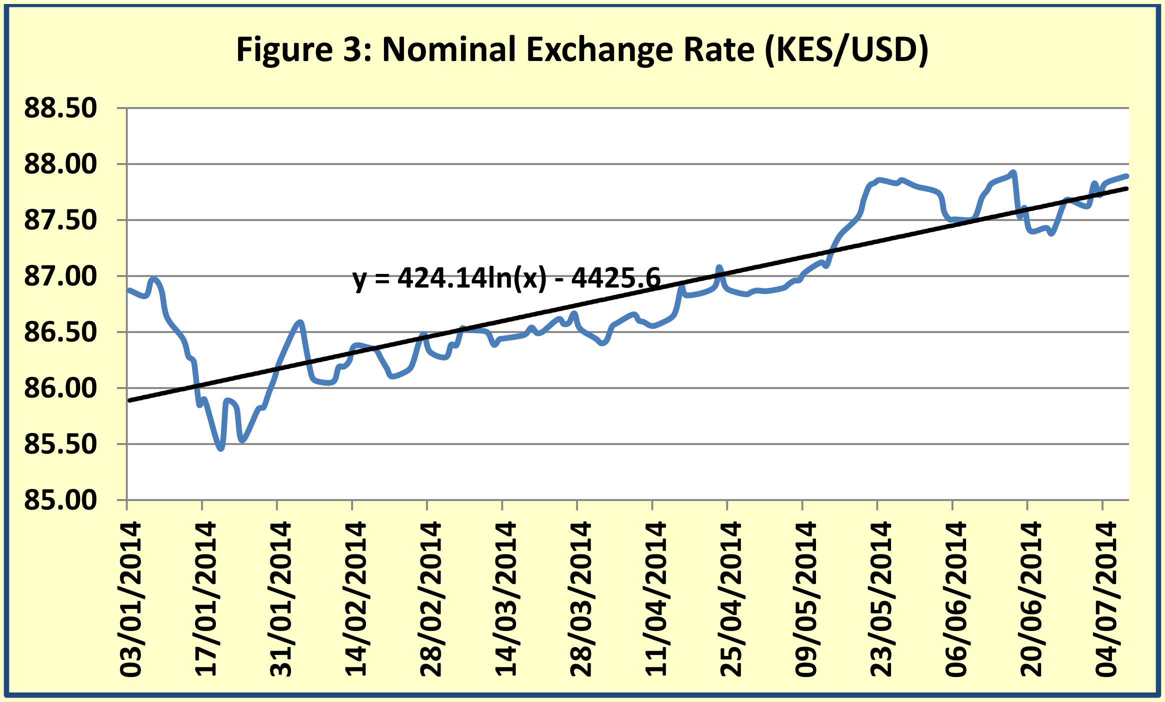
Source: International Monetary Fund

In is hardly surprising therefore that the Kenya Shilling, while largely stable as the MPC observes, has been subject to a depreciation bias (**Figure 3**). This *Research Note* maintains the outlook of our previous two *Research Notes*[2] that the local unit will maintain the weakening bias, at least for the next two quarters. The CBK's position of projecting market stability is based on three factors:

- One, continued flows of diaspora remittances;
- Two, Increased foreign investor participation at the Nairobi Securities Exchange; and
- Three, enhanced confidence and actual foreign exchange reserves by Kenya's successful debut Eurobond. The foreign currency reserves as at July 7, 2014 were at USD 6,501.37 million (equivalent to 4.34 months of import cover).

[2] Kenya Bankers Association Centre for Research on Financial Markets and Policy®, 2014, "Monetary Policy Stance – The Signalling Getting Better?", ***Research Note No.10. – 2014 (RN/10/14), April 5***; and Kenya Bankers Association Centre for Research on Financial Markets and Policy®, 2014, "Monetary Policy Stance – A Sound Decision Signalling Policy Credibility", ***Research Note No.8. – 2014 (RN/8/14), March 6.***

Therefore the reserves position provides adequate cushion for the CBK to manage temporary shocks that may affect the foreign exchange market. That by no means implies that the CBK is either in a position or is desirous to influence the *direction of the currency trend*.



Source: Central Bank of Kenya

We therefore hinge our currency weakening bias on three factors.

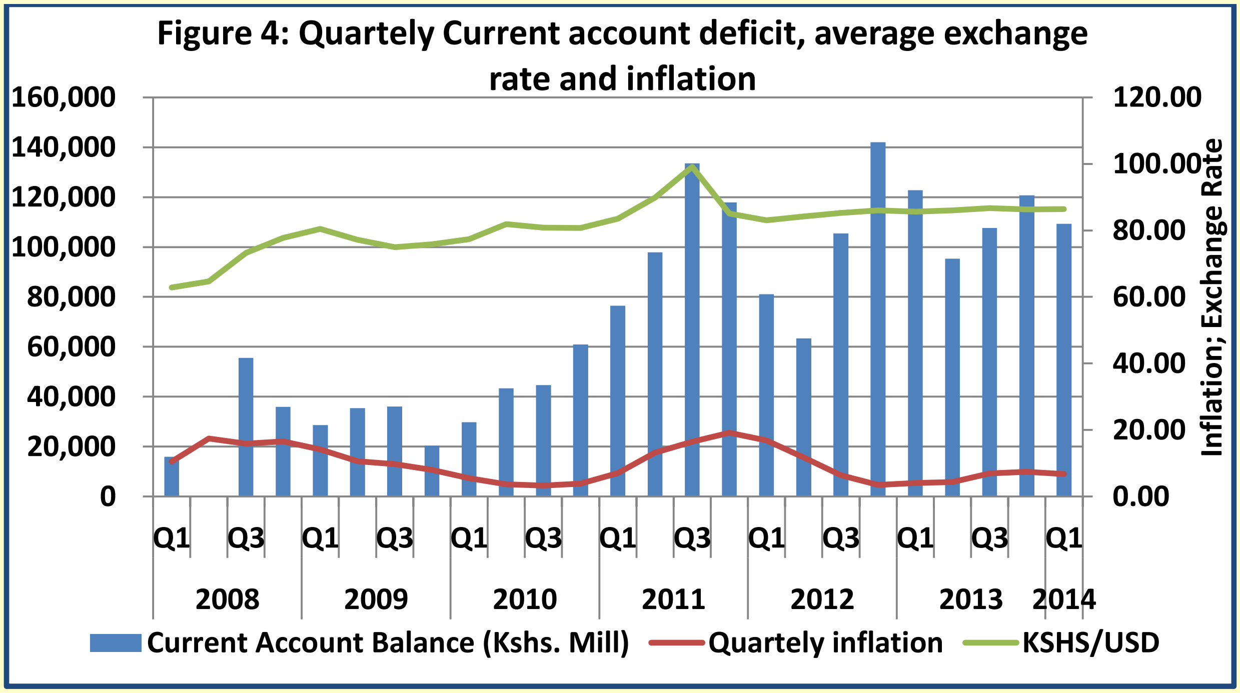
- First, with the likely food shortage following erratic rains in quarter one of 2014 that saw agricultural sector post a poor performance of 2.7 percent against 6.8 percent in quarter one of 2013 , the deficit can only be bridged by way of food importation. This adds up to the already existing heavy importation in attempt to fund the heavy physical infrastructure hence pilling up pressure on the shilling.
- Second, it's expected that the proceeds from the debut Euro Bond will ease pressure on the shilling in addition to increasing market liquidity. We argue that the bond issue comes at a critical time when the economy is projecting a budget deficit of approximately KES 190.8 billion for 2014/15 fiscal year. In addition, the extension of maturity for the syndicate loan of USD 600 million to August 2014 is merely a transfer of an obligation at an additional cost, and the obligation has to be met anyway. Given that it's barely one month to August, the significance of Euro bond in easing pressure on the shilling and further countering the so called "temporary shock" still remains uncertain.
- Third, the supply side of the forex market is unlikely to bring about market correction that can stabilize the shilling in the long run. This is informed by the poor performance in quarter one of 2014 as well as the on-going deterioration of the economy's top foreign exchange earners mainly the tourism sector and tea exports. In addition given the high price elasticity of demand and the low income elasticity of Kenya's exports abroad and further the small-open-economy nature, Kenya only remains to be a price taker at the world market and the ability to leverage on weakening currency through increased exports earning abroad is unrealizable.

We finally contend that even the factors that bolster MPC's optimism on the global economic prospects have a downside dimension. MPC correctly argues that global economy has picked, albeit in an uneven manner. However, the argument that such growth represents a potential boon for Kenya's exports is at best an assumption. The very fact that the observed growth is on the back of declining long-term interest rates – and the European Central Bank is now pursuing a negative interest rates policy – and the rates are likely to remain low implies that market volatility on developing economies arising from possible reverse flow of portfolio investments is obviated. Nonetheless, such market conditions imply that the weaknesses of the developed economies are deeply entrenched and may take long to unwind.

A Policy Dilemma in the Making?

The deprecation bias that we project and well as the possibility of inflation overshooting the upper bound target in the next quarter present a scenario with interesting market outcomes. As at the end of 2013/14 fiscal year, the economy current account deficit was estimated at 8 percent of the GDP. If the policy objective of the CBK is to address challenges of the external position that underpin the depreciation bias (the external balance) as well as simultaneously address local stability conditions (internal balance) then the correction can occur only if interest rates rise.

The movement in the inflation rate seems to be in tandem with the currency's fluctuations though with a lag (**Figure 4**). Therefore, with the weakening bias on the shilling, chances are that inflation rates keep on an upward trend as long as the current account deficit is unmanaged. Given the lag in the inflation trend relative to the shilling depreciation chances are that even if the shilling stabilizes, inflation rates are likely to be on an upward trend for a while. With the current account deficit at the current level while the economy grows at around 4 percent proper fiscal expenditure management coupled with the appropriate monetary policy is core in addressing any potential policy dilemma.



Source: Central Bank of Kenya

The government budget for 2014/15 fiscal year seems ambitious with the total expenditure net of domestic debt rollover estimated at KES 1,581 billion. Out of this, 190.8 billion - equivalent to 4.1 percent of GDP - will be funded by way of net domestic borrowing. The implication here is that the fiscal framework for 2014/215 is fully financed. However, implementing this budget comes with a number of challenges which spill over to the overall interest rates in the economy.

- The fiscal year will see the maturity of KES 325 billion public debt in 2015 with which Kshs.122.92 billion, KES 24.51 billion and KES 150 billion going towards internal debt interests, external debt interest and redeeming internal debts arising from the government borrowing using treasury bills and bonds respectively. This is in addition to the syndicate loan of USD 600 million.

- The budget comes at a time when the national treasury has raised the government's overdraft window at the central bank by KES 5 billion from the previous KES 34.2 billion to KES 39.1 billion. This sends a signal of the government's difficulty in mobilizing financial resources to finance its recurrent expenditure. The raising of the overdraft now constitutes 3.2 percent of the official debt of KES 1.2 trillion which ultimately affects the market liquidity.

Therefore the foregoing argument points to the slim possibility of the desired policy position of low interest rate. As we subsequently argue, even the successful Eurobond – on its own – may not lead to the low interest rates that official expectations are engendering.

The Eurobond: Magic Wand that May Never Be?

We have previously argued that the interplay between the foreign exchange market and the money market on the back of the Eurobond will have an influence on the direction of the short-term interest rates. The magnitude and the direction of that effect are however subject to a number of 'Ifs' surrounding the Euro bond.

One factor that is clear is that as already noted, out of the USD 2 billion raised by the Eurobond, USD 600 million has been used to retire the government's short term syndicated loan; Therefore USD 1.4 billion will be available for expenditure. The amount of foreign currency reserves available to the CBK will depend on what component of the syndicated loan will be channelled to off-shore accounts of lending principal banks or whether the funds will be channelled to their local subsidiaries; such reserves will also depend on whether the syndicated loan is rolled over.

Furthermore the resources will mostly be expended in local currency as the government seeks to meet its local obligations, which therefore means that liquidity may increase by a magnitude that will depend on the foreign currency that will be available for expenditure. If the government uses the entire proceed to finance infrastructure projects as has explicitly been stated as a basis for this bond, then there will be increased liquidity that will have the potential of lowering interest rates at the risk of mounting depreciation pressure on the local currency.

Given the potential destabilising effect of the currency depreciation, open market operations (OMO) to sterilise the liquidity may be inevitable given the MPC's comportment of seeking to entrench policy credibility of anchoring inflation expectations. This will have the potential implication of influencing an increase in interest rates. If however the government seeks to utilise the part of the proceeds to retire domestic obligations – and our conjecture is that there is a less disposition towards this option – then its effect will depend on which obligations are retired. In the event of those obligations being the overdraft with the CBK and the suspense account, then this move will be liquidity neutral. But in the event of the government utilising the proceeds to retire domestic debt, then there will be a liquidity increase that would necessitate OMO with the obvious influence on interest rates. Our conjecture is therefore that the effect on the Eurobond on both inflation and interest rates is likely to be neutral.

The Inaugural Kenya Banks Reference Rate (KBRR)

It is against the above background that the CBK announced the inaugural Kenya Banks Reference Rate (KBRR). The KBRR, computed based on the CBR and a 2-month moving average of the 91-Day Treasury Bill Rate, was set at 9.13 percent and will be reviewed after six months unless there are drastic changes in market conditions. This is one of the measures meant to enhance transparency in credit pricing. Whereas transparency may ultimately lead increased competitive pricing, the KBRR will only lead to lower lending rates if the two parameters that determine the benchmark rate assume a declining trend. The KBRR may be a necessary development but not sufficient on its own to result in sustainably low interest rates.

Conclusion

The decision of the MPC meeting of July 8, 2014 to hold the Central Bank Rate (CBR) at 8.5 percent was an affirmation of the desire to anchor inflation expectations. Informed expectations were that the CBR level will be unchanged. Nonetheless, the MPC's sanguine posture with regard to inflation outlook has to countenance the fact that new electricity tariffs come into effect in July 2014. This comes at a time when there is a possibility of an increase in food prices on account of supply constraints arising from erratic rains in quarter one of 2014. It is not just the local environment that begs for a continued pause in monetary policy stance. The external environment, particularly the geopolitical developments in Eastern Europe and the Middle East crisis have direct implications on domestic market dynamics. The interplay of such dynamics could result in at best slim possibility of the desired policy position of low interest rate. Even the successful Eurobond – on its own – may not lead to the low interest rates that official expectations are engendering.

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